Nos. 10,589, 10,590, 10,591, 10,592

IN THE

United States Circuit Court of Appeals

For the Ninth Circuit

NEW IDRIA QUICKSILVER MINING COMPANY (a corporation), *Petitioner,* vs. COMMISSIONER OF INTERNAL REVENUE, *Respondent.*	No. 10,589
KLAU MINE, INC. (a corporation), *Petitioner,* vs. COMMISSIONER OF INTERNAL REVENUE, *Respondent.*	No. 10,590
OAT HILL MINE, INC. (a corporation), *Petitioner,* vs. COMMISSIONER OF INTERNAL REVENUE, *Respondent.*	No. 10,591
WILD HORSE QUICKSILVER MINING CO. (a corporation), *Petitioner,* vs. COMMISSIONER OF INTERNAL REVENUE, *Respondent.*	No. 10,592

FILED

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On Petition for Review of Decisions of the Tax Court of the United States.

BRIEF FOR PETITIONERS.

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Table of Contents

Page

I. Matters required by Rule 20:

Opinion below 1

Jurisdictional statement 2

Questions presented—quicksilver mine depletion.... 3

Statutes and regulations involved................. 3

II. Statement of facts 4

III. Specifications of error 11

IV. Argument:

Summary 14

1. Tax Court's interpretation of Sec. 23(m) Rev. Code, upholding Reg. 103, Sec. 19.23 (m)-1-(f) as interpreted by respondent, amounts to a complete denial of petitioners' right under Sec. 114 (b) (4) Rev. Code to a deduction of 15% of the gross income from their properties to cover depletion thereof 16

2. Tax Court's construction of Reg. 103, Sec. 19.23 (m)-1-(f) (4) as calling for a hypothetical gross revenue based on calculated values of a non-marketable raw material does violence to both the intent of the regulation and its validity if it be subject to such interpretation 26

3. If quicksilver in flasks, ready for market, is the first marketable product from the mines, it necessarily follows that respondent's deduction of costs of furnacing, condensing, cleaning and flasking, from gross income from sales of quicksilver was improper and the Tax Court erred in upholding it 40

4. Arbitrary apportionment of gross profit to excluded operations and deduction of amounts thus apportioned was improper and Tax Court erred in upholding it 41

5. New Idria Quicksilver Mining Company was entitled to percentage depletion from dump ores which were always an integral part of its prop-

Page

erty, had never been severed in title therefrom, and as to which no depletion had ever been previously claimed 46

6. Oat Hill Mine, Inc. was entitled to deduct a power service charge from its gross income 53

V. Conclusion 54

Appendix—Statutes and regulations involved i

Table of Authorities Cited or Distinguished

Cases

Pages

Ambassador Petroleum Co. v. Commissioner, 81 F. (2d) 474, 477 (C.C.A. 9—1936) 26
Atlas Milling Co. v. Jones, 115 F. (2d) 61 (C.C.A. 10—1940) 46, 50

Blatt Co. v. United States, 305 U. S. 267, 279 (83 L. Ed. 167, 172) 23
Bowers v. West Virginia Pulp & Paper Co., 297 Fed. 225 (C.C.A. 2—1924) 23
Brea Cannon Oil Co. v. Commissioner, 77 F. (2d) 67, 68 (C.C.A. 9—1935) 36

Commissioner v. Kennedy Mining & Milling Co., 125 F. (2d) 399, 400 (C.C.A. 9—1942) 39, 46, 47
Commissioner v. Winslow, 113 F. (2d) 418, 423 (C.C.A. 1—1940) 21
Commodore Mining Co. v. Commissioner, 111 F. (2d) 131, 133 (C.C.A. 10—1940) 24
Consolidated Chollar, Gould & Savage Mining Co. v. Commissioner, 133 F. (2d) 440, 441 (C.C.A. 9—1943) 51
Consumers Natural Gas Co. v. Commissioner, 78 F. (2d) 161 (C.C.A. 2—1935) 36
Crews v. Commissioner, 89 F. (2d) 412, 415 (C.C.A. 10—1937) 31

Eisner v. Macomber, 252 U. S. 189, 207, 64 L. Ed. 521, 529 31

Greensboro Gas Co. v. Commissioner, 79 F. (2d) 701 (C.C.A. 3—1935) 35

Helvering v. Bankline Oil Co., 303 U. S. 362, 82 L. Ed. 897 35
Helvering v. Mountain Producers Corporation, 303 U. S. 376, 382, 82 L. Ed. 907 34
Helvering v. Reynolds Tobacco Co., 306 U. S. 110, 116, 83 L. Ed. 536, 541 46
Helvering v. Safe Deposit Trust Co. of Baltimore, 95 F. (2d) 806, 810 (C.C.A. 4—1938) 24
Helvering v. Twin Bell Oil Syndicate, 293 U. S. 312, 322, 79 L. Ed. 383, 389 31
Hesslein v. Hoey, 91 F. (2d) 954, 956 (C.C.A. 2—1937) 46

Pages

Lumaghi Coal Co. v. Helvering, 124 F. (2d) 645, 648 (C.C.A. 8—1942) 37

Maass v. Higgins, 312 U. S. 443, 447 (85 L. Ed. 940, 132 A.L.R. 1035, 1037) 23

Manhattan General Equipment Company v. Commissioner, 297 U. S. 129, 134, 80 L. Ed. 528, 531.......... 22

Standard Oil Company v. United States, 221 U. S. 1, 50, 55 L. Ed. 619, 641.......... 31

South Utah Mines & Smelters v. Beaver County, 262 U. S. 325, 332, 67 L. Ed. 1004.......... 52

United States v. City and County of San Francisco, 310 U. S. 16, 21, 84 L. Ed. 1050, 1055.......... 30

Statutes and Regulations

Internal Revenue Code:

Section 114-(b)-(4) ....16, 19, App. ii

Section 23 (m) ....App. i, ii

Treasury Regulations:

Reg. 103, Sec. 19.23 (m)-1-(f)(4)..........16, App. iii

Reg. 103, Sec. 19.23 (m)-1-(6)(2).......... 38

Congressional Record 1942, p. 8291.......... 27

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On Petition for Review of Decisions of the Tax Court of the United States.

BRIEF FOR PETITIONERS.

OPINION BELOW.

The opinion of The Tax Court of the United States, together with its findings of fact, is set forth in the

record, pages 89 to 109, and the formal decisions of the Court in each case appear in the record, pages 110 to 113.

JURISDICTION.

This petition for review involves assessed deficiencies in Federal corporate income taxes, as follows:

Docket No. 10,589—New Idria Quicksilver Mining Company:

Fiscal year ended June 30,

1939	$ 107.22
1940	4,883.21
1941	9,879.94

Docket No. 10,590—Klau Mine, Inc.:

Calendar year

1940	$3,834.70

Docket No. 10,591—Oat Hill Mine, Inc.:

Calendar year

1940	$2,025.10

Docket No. 10,592—Wild Horse Quicksilver Mining Co.:

Fiscal year ended September 30,

1940	$1,344.63

Decisions of The Tax Court of the United States approving the above assessments under said respective docket numbers were entered on August 13, 1943. (R. 110-113.) Petitions for review were filed October 12, 1943. The jurisdiction of this Court is invoked under Section 1141, Title 26, U.S.C.A. by the petitioners, all of whose returns were filed in collector's offices located

within the Ninth Circuit. A consolidated record on review and a stipulation for consolidation of all four cases for briefing and decision on review is submitted. (R. 127-129.)

QUESTIONS PRESENTED.

The questions presented on review may be summarized briefly under the following headings:

(1) Whether the petitioners correctly computed percentage depletion in rendering their respective corporate income tax returns for the years in question;

(2) Whether the petitioner New Idria Quicksilver Mining Company was entitled to deduct percentage depletion on ore mined from certain dumps on its property;

(3) Whether petitioner Oat Hill Mine, Inc. was entitled to deduct as an operating expense certain service charge deposits required by the power company serving said petitioner with electric energy during the years in question.

STATUTES AND REGULATIONS INVOLVED.

The statutes and regulations involved are set forth in the Appendix, *infra,* pages i-vi.

STATEMENT.

Petitioners, during the years in question and for some years preceding, had been operating quicksilver mines in California and Nevada. New Idria Quicksilver Mining Company owns and operates a quicksilver mine located in San Benito County, California. Klau Mine, Inc. owned and operated during the year in question a quicksilver mine situated in San Luis Obispo County, California. Oat Hill Mine, Inc. leased and operated a quicksilver mine in Napa County, California. Wild Horse Quicksilver Mining Co. owned and operated a quicksilver mine in Churchill County, Nevada.

The sole product produced by each petitioner was quicksilver metal (also known as mercury). With the exception of the metal produced from dumps on the New Idria property, to which reference will later be made, all of this metal was obtained from crude cinnabar ore mined and extracted by surface and underground mining operations. (R. 30.) Subterranean workings consisted of drifts and crosscuts. The ores were broken down by blasting and thereafter sorted. The material which did not contain cinnabar (which is the ore from which quicksilver is produced) was discarded and the cinnabar ore was hauled to the surface by cars. There it was screened and crushed into small particles of two inches or less and carried by conveyors to furnaces. At the New Idria Mine two furnaces were operated. They are of the rotary type, five feet in diameter and fifty-six feet in length, made of iron and lined with fire brick. (R. 30.) At each of the other mines there was only one furnace,

which was a smaller one than at New Idria. The crushed ores are fed into the furnaces and heated to a temperature of about 1200 Fahrenheit. The effect of this heating is to disintegrate the ore and drive off the quicksilver vapors. These vapors as they are released by the heat are drawn from the furnace by suction fans and passed into the condenser system, which consists at the New Idria Mine of two vertical banks of ten pieces of sixteen inch iron pipe each, with rubber buckets at the bottom of the pipes to collect condensed mercury. Similar systems with smaller condensers existed at the other mines. These buckets are emptied on tables where the contents are mixed with slack lime and worked with hoes to cleanse or free the quicksilver. After this operation the quicksilver is practically pure and is flasked for market.

This method of extracting quicksilver is similar in many respects to the method used in extracting free gold from gold ores through the use of stamp mills and amalgamation with quicksilver placed on the plates, over which the ore is washed by water after being crushed by the stamps. The free gold is caught by the quicksilver, amalgamates with it, and is then separated from the amalgam by heating and driving off the mercury vapor. (R. 72.) In both cases the first marketable product recovered from the mine is the metal itself in a practically pure condition.

Experiments have been made from time to time in prior years, by the petitioners and other operators, with different methods such as gravity and flotation

methods, for concentrating the cinnabar ore before furnacing and condensing it. (R. 65-72; 74; 80-81.) None of these experiments have proven successful in the United States for economic reasons. It is physically possible to concentrate cinnabar ore, or we presume, any other ore; but after the quicksilver concentrates are obtained they still have to be roasted in the same manner as the crude ores, and practically no saving in cost is gained by concentration. There are no custom mills in the United States which purchase cinnabar ore or concentrates for reduction. There is no market for cinnabar ore in its crude state. The reason for this is that mercury ores as known in this country are relatively low grade, containing from two to forty pounds of quicksilver to the ton and averaging about five to six pounds. This means that out of every ton of ore transported, 1995 pounds would be rock having no value whatever, and only five pounds would be valuable metal. (R. 66; 79.) For like reason, perhaps in lesser degree, there is no market for quicksilver concentrates, and they are not made in commercial practice. It necessarily follows that each quicksilver mine must have its own furnace, which is just as much an essential element in producing its product as would be the mine hoist or crusher. In no instance is there a marketable product derived from the mine until the ore broken down in the face of workings has been transported to the surface, crushed, roasted, and the quicksilver vapors condensed, cleaned, and placed in flasks. At this point, and not until then, does a marketable product exist at the mine.

In the cases at bar all of these operations were conducted on the respective properties by the owners thereof, and the flasked quicksilver was then sold in the open market. Petitioners' witnesses, all of whom were well qualified to speak, testified, without contradiction, that the roasting of the cinnabar ore and the vaporization and condensation of the quicksilver are similar in effect to the crushing and gravity concentration of gold ores in quartz mills. (Walter Bradley, R. 72; Worthen Bradley, 75; Gould, 80.) No chemicals are added in the furnace. The process is a physical process of adding heat to the crude ore. The disintegration of the ore frees the quicksilver from the other minerals with which it is associated in the ore. Condensation is merely a matter of cooling the vapors.

In the case of the New Idria Mine, there are located on the petitioner's property large dumps containing ore which in years prior to 1913 was mined by former owners of the property from the property on which they are located, but was not furnaced because of its low grade. Mine operations have been carried on on this property continuously since about 1858. (R. 31-34.) These dumps have in some instances been covered with waste and mined in more recent years. Title to them was never severed from the property on which they are located and from which the ores in them came, but the dumps have regularly passed down from owner to owner, and finally in 1936 to the petitioner, as a part of the land on which they were situated, no separate value having ever been assigned

to them. There were also on this same property certain dumps containing partially burned ores which had been discarded from the less efficient furnaces formerly used in roasting ore mined from the property. These burnt ore dumps contain partially burned ore, mined from the same property, from which mercury can be profitably recovered under the modern improved methods of roasting used by petitioner. (R. 83.) No depletion has ever been claimed in tax returns made by former owners covering any of the ore in either of these dumps. (R. 34.)

During the taxable years in question the petitioner mined ores from both these dumps by the use of steam shovels and passed them through its furnaces, thereby obtaining considerable quantities of mercury therefrom in addition to whatever had been formerly extracted by petitioner's predecessors in title. These ores are situated on the same land holding as the furnace, at a distance of about a mile and a half from the roasting plant. The gross sales of quicksilver made and reported by petitioner in its income tax returns during each of the taxable years included the sales of mercury obtained from these dump ores. The returns from dump ores, however, are separately shown in the record. (R. 34.)

There were no dump ores mined from properties of the other three petitioners.

Each of the petitioners elected to claim percentage depletion as a deduction in its income and declared value excess profits tax returns for the taxable years in question, computing this percentage on the total

gross sales of quicksilver from all sources. (R. 95-96.) The respondent Commissioner insisted that there should be deducted from the gross revenue obtained from said sales of quicksilver in each case the costs of transporting, furnacing, condensing, cleaning, and flasking, in amounts which were agreed as representing the cost of such items, together with an assumed profit on each operation which was determined by applying to the total profits from sales of quicksilver that percentage which the cost of each of said operations bore to the total cost of all operations involved in getting the quicksilver from its place in the ground into the market. The Tax Court upheld these contentions. (R. 104.) The effect of these deductions was to treat as gross income from petitioner's property for depletion purposes, the actual cost of mining and crushing the ore, plus the percentage of the total profit which this cost bore to the total costs of all operations. It is not pretended, we repeat, that any crude ore was ever sold at such profit or could have been sold at such profit, or was or could have been sold at all. The calculation of "gross income from the property" was therefore a purely arbitrary calculation which the respondent adopted for the purpose of determining what he considered gross income from the property for depletion purposes. In the case of the New Idria Mine respondent excluded entirely from the depletion base all income from quicksilver derived from ores in the dumps above described and was upheld by the Tax Court in so doing. (R. 106.)

In the case of the Oat Hill Mine, the petitioner had paid to the Pacific Gas and Electric Company in 1940 the sum of $3,750.00, constituting a deposit payment to justify that company in installing an electric transmission line and transformers on petitioner's property. The payment was made under a contract which provided that all of the equipment so installed should remain the property of the Pacific Gas and Electric Company. (R. 58.) Provisions were made in the contract for reimbursement over a long period of time of this line extension deposit if thirty-six months should have elapsed before discontinuance of operations on petitioner's property. The petitioner's manager testified, without contradiction, that in 1940, when this payment was made, the apparent life of the operation at the Oat Hill Mine would not outlast the war, or probably about three years. (R. 83-84.) There would thus be no opportunity for refund of any portion of this deposit. Petitioner deducted this payment to the power company as an operating charge in its income tax return. The respondent refused to allow the deduction, claiming that it was a capital charge, and would not permit the deduction either in one year or its amortization over a period of three years. The Tax Court upheld respondent's disallowance of this item. (R. 107.) Petitioner Oat Hill Mine, Inc. was thus deprived of any deduction for this payment in its income tax returns as an operating expense, although it acquired no capital asset of any kind whatever in return therefor. The record shows that petitioner was dissolved as a corporate entity in December, 1941.

SPECIFICATIONS OF ERROR.

The errors relied upon for reversal of the ruling of the Tax Court may be grouped into three classes:

(1) Errors common to all four cases under review (R. 116-118):

1. The Tax Court erred in upholding the Commissioner's method of computing allowable depletion on the properties owned by petitioner for each of the fiscal years in question.

2. The Tax Court erred in upholding the Commissioner's contention that the depletion allowed by him for each of the fiscal years in question was based by him on 15% of the gross income from the property, or 50% of the net income therefrom, whichever was lower, as used in United States Revenue Code Section 114-b.

3. The Tax Court erred in upholding the Commissioner's failure to determine the fair market value of the first marketable product from petitioner's mine as constituting the gross income as a basis for the purpose of computing percentage depletion under the provision of Regulations 103 of the Bureau of Internal Revenue, Section 19.23 (m)-(1), for each of the fiscal years in question.

4. The Tax Court erred in holding as a basis for the deduction specified in the foregoing assignments that quicksilver ore was the first marketable product derived from petitioner's operations, whereas it appears from the undisputed facts in the record that quicksilver metal or mercury was and is the first marketable product derived from said operations.

5. The Tax Court erred in not accepting as the gross income from said property as a basis for the purpose of computing percentage depletion allowance to petitioner in its income tax return the gross return from sales of mercury derived from said properties, as shown by undisputed facts in the record, for each of the said fiscal years in question.

6. The Tax Court erred in upholding the ruling of the Commissioner to the effect that the gross income from petitioner's property during each of said fiscal years in question should be determined by deducting from the gross proceeds of sales of metal the amounts claimed by the Commissioner, or any other amounts, representing the cost of furnacing, condensing, cleaning and flasking the ores extracted from petitioner's mine, and separate error is alleged as to each of said items of deduction.

7. The Tax Court erred in subtracting from the gross income to petitioner from sales of quicksilver metal from petitioner's property during each of said fiscal years in question the amount claimed by the Commissioner, or any other amount, purporting to represent the proportion of petitioner's operating profit alleged to have been derived from the operations of furnacing, condensing, cleaning and flasking said ores extracted from petitioner's property, or the metal contained therein, or from any of said items.

8. The Tax Court erred in assuming as a basis for said deduction that any profit whatever was derived by petitioner from the operations of furnacing, cleansing, condensing and flasking of quicksilver ore mined

and extracted from petitioner's property during the period in question, and in failing to assume that such profit as petitioner derived from such operations was ascribable wholly to the existence of quicksilver ore in petitioner's mine and of an open market for the metal extracted therefrom and processed thereon.

9. The Tax Court erred in sustaining the Commissioner's contention that the gross income from the property as defined by the United States Revenue Code, Section 114-b, as a basis for percentage depletion, can be ascertained by arbitrarily adding to the cost of mining and crushing ore extracted therefrom a percentage of the net profit from sales equal to the proportion that the cost of mining and crushing bore to the total cost of mining, crushing, furnacing, condensing, cleaning, flasking, and transporting the metal to market, and all other costs of operation.

(2) Error peculiar to the new Idria Quicksilver Mining Company case, Docket No. 10589 (R. 118):

(10) The Tax Court erred in sustaining the Commissioner's ruling in Docket No. 10,589 that petitioner was not entitled to claim percentage depletion on the income from ore mined and extracted from dumps on petitioner's property, which dumps contained ore extracted from the identical property on which said dumps were located, which was originally mined by petitioner's predecessors in interest from said property and as to which no depletion allowance had ever been previously claimed, either by petitioner or by its predecessors in interest.

(3) Error peculiar to the Oat Hill Mine, Inc. case, Docket No. 10591 (R. 134):

(11) The Tax Court erred in sustaining the Commissioner's ruling that petitioner was not entitled to claim deduction as an operating expense during said taxable year in the sum of $3,750.00 representing a payment made to Pacific Gas and Electric Company as a payment for power service.

ARGUMENT.

SUMMARY.

(1) The Tax Court's interpretation of Section 23 (m) of the Internal Revenue Code upholding Rules and Regulations 103, Section 19.23 (m)-1-(f) (4), as interpreted by the Commissioner, amounts to a complete denial of the right of petitioners under Section 114-(b) (4) Internal Revenue Code in ascertaining their corporate income taxes, to a deduction of 15% of the gross income from their properties to cover depletion thereof. (Specifications Nos. 1 and 2.)

(2) The Tax Court's construction of Regulations 103 of the Bureau of Internal Revenue, Section 19.23 (m)-1-(f) (4), as calling for a hypothetical gross revenue from a non-marketable raw material does violence to both the intent of the regulation and its validity if it be subject to such an interpretation. (Specifications Nos. 3, 4 and 5.)

(3) If, as petitioners contend, quicksilver in flasks, ready for market, is the first marketable product at the mine, it necessarily follows that the respondent's

deduction of costs of furnacing, condensing, cleaning and flasking from their gross income from sales of quicksilver was improper, and the Tax Court erred in upholding it. (Specification No. 6.)

(4) To an even greater degree, the Tax Court erred in upholding the arbitrary apportionment and deduction of profit so apportioned to each of these excluded operations adopted by the respondent Commissioner in assessment of petitioners' taxes. (Specifications Nos. 7, 8 and 9.)

(5) Petitioner New Idria Quicksilver Mining Company was entitled to claim percentage depletion on income from ore mined and extracted from dumps on its land which dumps were always an integral part of its property, had never been severed in title therefrom, and as to which no depletion had ever been claimed previously. (Specification No. 10.)

(6) Petitioner Oat Hill Mine, Inc. was entitled to deduct from its tax return the payment made to the Pacific Gas and Electric Company for power service. (Specification No. 11.)

(1) THE TAX COURT'S INTERPRETATION OF SECTION 23 (m) OF THE INTERNAL REVENUE CODE UPHOLDING RULES AND REGULATIONS 103, SECTION 19.23 (m)-1-(f)(4), AS INTERPRETED BY THE COMMISSIONER, AMOUNTS TO A COMPLETE DENIAL OF THE RIGHT OF PETITIONERS UNDER SECTION 114-(b)-(4) INTERNAL REVENUE CODE IN ASCERTAINING THEIR CORPORATE INCOME TAXES, TO A DEDUCTION OF 15% OF THE GROSS INCOME FROM THEIR PROPERTIES TO COVER DEPLETION THEREOF. (SPECIFICATIONS NOS. 1 AND 2.)

In its opinion and findings (R. 101-104) the Tax Court tacitly admits that Regulations 103, Section 19.23 (m)-1-(f) (4), as drafted do not fit the particular conditions of quicksilver mining. Nevertheless the Court says the purpose of the regulations

> "is to compute the percentage depletion allowances for all types of mines on the basis of income attributable to the using up or the 'depletion' of the mineral or metal products as distinguished from the income attributable to the various processes utilized in preparing the product for the market. We can not say that in their plan for furtherance of that purpose the regulations are so contrary to the statute or so out of harmony with the meaning and purpose of the statute as to be invalid." (R. 101.) * * *
>
> "We think that the result which the respondent has reached here by applying his regulations comports with the purpose of section 114 (b) (4) I.R.C. as that section has been construed by the courts. The position taken by the petitioners that their percentage depletion on quicksilver mines should be computed upon the total gross sales of mercury as finally processed is, we think, contrary to the purpose of the statute." (R. 104)

Petitioners assert that the regulations, as interpreted by the respondent and by the Tax Court do violence to the clear intent of Section 114 (b) (4) of the statute, and for that reason are in error. In making this assertion, petitioners have no quarrel with the general principle announced that "gross income from the property" upon which percentage depletion is required to be computed by the provisions of Section 114 (b) (4) is intended to be income from the first marketable product which can be produced from the property and is not to be income attributable to refining or distribution processes. Nevertheless, income is income. It is not a hypothetical calculation of sale values of raw materials as distinguished from the value of the capital asset from which they are produced.

Respondent will undoubtedly concede that ore in the face of the drift is not income, although its discovery may add to the market value of the property as a whole. Respondent will not claim that percentage depletion could or should be computed on that increase in value so long as the ore remains in place. Let us go a step further,—the ore is broken down in the mine by the use of machinery, equipment and labor. It is still not income, or convertible into income, although it is raw material capable of being processed to a degree that it will have a market value and yield income. It has merely been separated from the land from which it came by the use of mining processes. The ore is transported to the mine portal. It is still not income upon which percentage depletion

can be computed, or upon which an income tax should be paid. Respondent does not contend that. In the instant case the ore at the portal of the mine could not be sold. Due to its small mineral content no one would pay the cost of transporting it. The owner has not yet converted it into a marketable product from which alone income could be obtained. The ore is given a primary crushing. This still does not make it income under the respondent's construction of his regulations, even though machinery and labor are involved in that process. The crushed ore is not a marketable product. It could not be sold.

The producer of the ore then takes the next step. He conducts it through a rotary furnace and by simply rotating it and adding heat the mercury vapors are driven off, condensed, and cleaned mechanically from the carbon and other worthless material which has come down with the vapors in condensation. Then for the first time mercury is obtained and is placed in flasks so that it can be handled, shipped and sold. We now have a marketable product—something that can be converted by sale into income from the property and it is the first marketable product that has been obtained in the whole operation. At no time prior to the pouring of this metallic mercury into the flasks has the owner had anything that he can sell to anybody who would be willing to buy it, or which could be treated as an economic entity, separate from the property from which it came. The record is absolutely without dispute as to these facts. The situation is not peculiar to petitioners' mines. It

is common to the entire quicksilver industry throughout the United States.

The question then arises as to whether the beneficiation of the ore which took place in the rotary furnace and in the condenser system is in any different legal category than the preceding processes of mining and crushing which were necessary to extract the ore from the ground, bring it to the surface and rendered it workable. We can perceive no legal distinction. If mercury ore at the mouth of the mine were salable, as, for example, wet gas is salable at the mouth of an oil well to a gasoline processing company, or as high grade ore might be salable to a custom mill, we could see some basis for the contention that further processing of the gas or ore would amount to an increase in the market value of the product over that which existed at the mouth of the mine due to a manufacturing process. But this is not true of quicksilver ores, either in petitioners' mines or elsewhere in this country.

We say therefore that the construction by the Commissioner and the Tax Court of Regulations 103 does violence to the manifest intent of both the regulation and the statute upon which it is based. Regulations 103, Sec. 19.23 (m)-1-(f)-(4), provide that in the case of ores "which are not customarily sold in the form of the crude mineral product" there should be no deduction in arriving at gross income from the cost of crushing and concentrating (by gravity or flotation) and other processes to the extent to which they

do not beneficiate the product in greater degree (in relation to the crude mineral product on the one hand and the refined product on the other) than crushing and concentrating (by gravity or flotation).

It was the obvious intent of this regulation, if we read it correctly, that no deduction should be made from gross income for the cost of such beneficiation processes as would bring a non-salable crude mineral product to the first stage at which it could be sold and disposed of in the market. In the case of the ores enumerated in the regulation, namely, lead, zinc, copper, gold and silver ores, it is ordinarily, though not always true that concentrates can be produced by gravity or flotation processes which will give a marketable product, one that could either be still further refined on the producer's premises or sold to a commercial smelter or refinery. Thus, even if in those cases actual money were not received for the crushed and concentrated ore by the producer, he would have a product which could be converted into cash income, and the salable value of that product might very well be taken as "gross income from the property" within the meaning of Section 114 (b) (4). However, where —as in the case of quicksilver mines—no salable product is produced by crushing; where concentration has proven to be uneconomical and is never used in practice; we say and petitioners' witnesses say that the roasting and condensing process does not beneficiate the crude mineral in any *relatively* greater degree than crushing and concentration would in the case of marketable concentrates.

The attempt which the Tax Court has made in response to the respondent's argument to create a hypothetical market value which does not and could not exist and then call it "gross income" amounts to a direct violation of the express language of Section 114 (b) (4), which entitles the petitioners to compute percentage depletion on the basis of the gross income from the property. Such interpretations have not been approved by the Courts. We refer first to the case cited by the Tax Court itself as supporting its construction. (R. 101.)

> *Commissioner of Internal Revenue v. Winslow,* 113 Fed. (2d) 418 (C.C.A. 1-1940), at 423:
>
> "(8, 9) The Commissioner of Internal Revenue has authority to prescribe rules and regulations to administer the Revenue Act of 1934, under the power conferred upon him by Section 62 thereof. Sec. 62, 48 Stat. 700, 26 U.S.C.A. Internal Revenue Acts, page 687. Any regulation consistent with the law is valid and its promulgation a proper exercise of the power conferred upon him, but it does not empower him to change or alter the law.
>
> 'The power of an administrative officer or board to administer a federal statute and to prescribe rules and regulations to that end is not the power to make law * * * but the power to adopt regulations to carry into effect the will of Congress as expressed by the statute. A regulation which does not do this, but operates to create a rule out of harmony with the statute, is a mere nullity.' Manhattan Co. v. Commissioner, 1936, 297 U. S. 129, 134, 56 S. Ct. 397, 400, 80 L. Ed. 528; Cf. Miller v. United States,

1935, 294 U. S. 435, 439, 55 S. Ct. 440, 79 L. Ed. 977.

'* * * although it is true that where an Act uses ambiguous terms or is of doubtful construction, a clarifying regulation or one indicating the method of an Act's application to specific cases is to be given weight by the courts, the interpretation of a statute always remains the function of the judiciary. The regulation cannot change what the Act originally meant.' Saks v. Higgins, D.C.S.D.N.Y. 1939, 29 F. Supp. 996, 999; cf. Fresno Grape Products Corp. v. United States, Ct. Cls. 1935, 11 F. Supp. 55, 59.

(10) Article 22 (b) (1) of Treasury Regulations 86, as sought to be applied by the Commissioner to the facts in this case, is contrary to the expressed intention of Congress and is invalid."

This principle has been upheld by the Supreme Court of the United States repeatedly. We refer to *Manhattan General Equipment Company v. Commissioner of Internal Revenue,* 297 U.S. 129, 134, 80 L. Ed. 528, 531:

"The power of an administrative officer or board to administer a federal statute and to prescribe rules and regulations to that end is not the power to make law—for no such power can be delegated by Congress—but the power to adopt regulations to carry into effect the will of Congress as expressed by the statute. A regulation which does not do this, but operates to create a rule out of harmony with the statute, is a mere nullity. Lynch v. Tilden Produce Co., 265 U.S. 315, 320-322, 68 L. ed. 1034-1036, 44 S. Ct. 488; Miller v. United States, 294 U. S. 435, 439, 440,

79 L. ed. 977, 980, 981, 55 S. Ct. 440, and cases cited. And not only must a regulation, in order to be valid, be consistent with the statute, but it must be reasonable. International R. Co. v. Davidson, 257 U.S. 506, 514, 66 L. ed. 341, 346, 42 L. ed. 179. The original regulation as applied to a situation like that under review is both inconsistent with the statute and unreasonable."

A Treasury regulation may not expand or contract the scope of a Congressional Act. It merely interprets it.

M. E. Blatt Co. v. United States, 305 U.S. 267, 279 (83 L. Ed. 167, 172).

"Treasury regulations can add nothing to income as defined by Congress."

Maass v. Higgins, 312 U.S. 443, 447 (85 L. Ed. 940, 132 A.L.R. 1035, 1037:

"On the other hand, the petitioners insist that the Government's position is unreal and artificial; that it does not comport either with economic theory or business practice; and that the regulation is an unwarranted extension of the plain meaning of the statute and cannot, therefore, be sustained. We hold that the petitioners are right."

Bowers v. West Virginia Pulp & Paper Co., 297 Fed. 225 (C.C.A. 2–1924):

"Changes in Treasury decisions do not change the law, but merely announce a change in some official's opinion about the law."

It is further ruled by the Courts that the Treasury may not depart from the realities of facts in making its regulations and base them on abstract logic (or much less, upon the lack of any logic, as is the case here).

We refer to the case of

Helvering v. Safe Deposit & Trust Co. of Baltimore, 95 Fed. (2d) (C.C.A. 4–1938), 806, 810.

In this case it was held that the Commissioner's interpretation of Section 303, Revenue Act of 1926, which required an estate tax to be based on the market value of property at date of death, as justifying a valuation of 25,000 shares of stock on the basis of what a small number of shares sold for on that date, created a rule out of harmony with the statute. Such a rule is not to be given weight as an executive determination.

Section 23 (m) of the Internal Revenue Code providing for a reasonable allowance for depletion in the case of mines to be made under rules and regulations to be prescribed by the Commissioner, does not, we submit, detract in any way from the mandatory language of Section 114 (b) (4), which allows percentage depletion in the case of metal mines to be taken in an amount equal to 15 per cent of the gross income from the property. The two sections are to be read together.

In *Commodore Mining Co. v. Commissioner of Internal Revenue,* 111 F. (2d) 131 (C.C.A. 10–1940), it was held (p. 133):

"* * * But all of these provisions must be read and considered together as parts of the whole. Section 23 (m) cannot be segregated and construed to grant a right to a deduction to be computed on any basis other than that provided in section 114. That Congress intended in Section 23 (m) to grant in the case of a metal mine a deduction to be computed in the manner set forth in section 114, and not otherwise, is plain."

The permission granted the Commissioner under Section 23 (m) to prescribe rules and regulations certainly cannot be interpreted as entitling him to depart from the mandatory language of Section 114 (b) (4) basing percentage depletion allowance upon "gross income from the property". If the respondent in computing that gross income may lawfully deduct the cost of furnacing, condensing and flasking the mercury vapors, we assert that he might with equal propriety deduct the cost of crushing, transporting the ore to the mine mouth and breaking it down in the face. All of these acts require the employment of labor and equipment, probably no less in value or magnitude than that required for the simple operation of furnacing and condensing. If the Commissioner may lawfully deduct the cost of a part of the operations necessary to get a marketable product, why may he not deduct the cost of all of them? Then we would have depletion based on *15 per cent of the net income,* whereas Section 114 (b) (4) says the alternative limit of percentage depletion is to be *50* per cent of the net income. The statute expressly gives the taxpayer the right to depletion based on

15 per cent of the *gross,* but not exceeding 50 per cent of the *net.* In this particular instance the Commissioner has not gone so far as to deduct all of the costs, but if the construction the Tax Court places upon Regulations 103, Sec. 19.23 (m)-1-(f) (4), is correct, there seems to be no good reason why he may not defeat the intent of Section 114 (b) (4) of the statute altogether and limit the taxpayer to 15 per cent of the net income rather than the gross. See,

> *Ambassador Petroleum Co. v. Commissioner of Internal Revenue,* 81 Fed. (2d) 474 (C.C.A. 9–1936),

where it was held (p. 477):

> "It can therefore be seen that the administrative and legislative history of the 1926 statute establishes that 'net income * * * from the property' and 'operating profit' are synonymous."

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(2) THE TAX COURT'S CONSTRUCTION OF REGULATIONS 103 OF THE BUREAU OF INTERNAL REVENUE, SECTION 19.23 (m)-1-(f)(4) AS CALLING FOR A HYPOTHETICAL GROSS REVENUE FROM A NON-MARKETABLE RAW MATERIAL DOES VIOLENCE TO BOTH THE INTENT OF THE REGULATION AND ITS VALIDITY IF IT BE SUBJECT TO SUCH AN INTERPRETATION. (SPECIFICATIONS NOS. 3, 4 AND 5.)

A portion of the argument we have made under the first point undoubtedly supports our second point as well. We do assert, however, that it was never the intent of Congress in enacting Section 114 (b) (4) that the Treasury Department should have the right to go so far as it has gone in its interpretation of Section 23 (m), I.R.C., by Regulation 103,

Sec. 19.23 (m)-1-(f), and that Congress has never given such interpretation any support. The position of the present Secretary of the Treasury in connection with percentage depletion allowances in general on mineral properties is so well publicized as to be of general knowledge. Each year he has, through his representative, appeared before the House and Senate Committees urging the entire abolition of percentage depletion, and each year his requests have been denied by the Congress. This attitude of the Treasury has given rise to Congressional debates.

The intent of Congress in using the words "gross income from the property" in the Revenue Acts as a basis for percentage depletion, has been argued and considered by Congress and its committees. The latest expression of the intent of Congress may be found in the record of the debate on the Senate floor on adoption of the 1942 Act, at page 8291, of the Congressional Record for that year. Senator George, Chairman of the Senate Finance Committee, had the floor, and was explaining the Revenue Act. Senator Johnson of Colorado was another member of the Senate Finance Committee. Senator Thomas of Idaho was interested in ascertaining the attitude of the Treasury on this very question, and the following debate took place:

> "Mr. George. I yield to the Senator from Idaho. I understand he has a matter which he wishes to present.
>
> Mr. Thomas of Idaho. Mr. President, I should like to have the attention of the senior Senator from Colorado. (Mr. Johnson.)

Mr. George. Yes; I should like to have the Senator from Colorado give attention to what the Senator from Idaho wishes to say.

Mr. Thomas of Idaho. When the amendments providing for percentage depletion were under consideration in 1932, it was our understanding that the ordinary treatment processes which a mine operator would normally apply in order to obtain a suitable product should be considered as a part of the mining operation. Is any change in that law proposed at this time?

Mr. Johnson of Colorado. Mr. President, I am glad the Senator brought up that subject, because it is one in which the Senator from Colorado has been very much interested, and it has been discussed in the Senate Finance Committee at considerable length. I am especially interested in the beneficiation of quicksilver, although no quicksilver is produced in the State of Colorado. But we have been met with this sort of situation with respect to quicksilver. If the producers of quicksilver will follow a certain process of beneficiation, they will receive the benefits of depletion fully, but if they adopt a more scientific method and a more modern method, then, of course, they run immediately into certain difficulties. That, to me, is something which is directly opposed to the public interest, and especially when we need quicksilver as badly as we do.

The question of what constitutes net income attributable to the mining of strategic metals and the companion questions regarding gross and net income from the property for percentage depletion have been considered with Mr. Randolph

Paul, who has represented the Treasury before the Finance Committee on this subject. Mr. Paul urged that this was a subject which should be covered by Treasury regulations rather than by detailed provisions of the law. I agree that the statutes should not be burdened with regulatory details to fit every possible contingency. I hope the Senator from Idaho will not offer an amendment on the subject at this time.

***The Congress has not intended in the pending measure to make any change in its concept of mining income from that expressed in the 1932 and 1934 acts, nor to establish by implication or otherwise any approval of Treasury regulation or Revenue Bureau practice which departs from the original acts or the general Bureau practice prior to 1940.*

I have conferred with Mr. Paul and he has stated to me the Treasury's intention to adhere to the original regulations and procedures under these acts, so that concentration by gravity or flotation and equivalent processes would be considered as part of the mining operation. *Thus, for example, the furnacing of quicksilver ores would be considered as an equivalent of concentration by gravity or flotation.*

Mr. Paul made only one exception to the original regulations; namely, that there would be excluded from gross income from the property not only the cost of further processes such as smelting, but also the profits if any, attributable thereto; intending thus to make the charges for

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*Italics used in this brief supplied unless otherwise noted.

a mining company's own smelter compare with those of an independent custom smelter.

Mr. President, does that explain the situation to the Senator from Idaho, and is he satisfied with the explanation?

Mr. Thomas of Idaho. Mr. President, I think with that explanation, the situation is entirely satisfactory. *What I was particularly anxious to know was whether the provision in question would make any changes in the matter of depletion in the operations to which I referred. I was very active in 1932 in connection with the passage of the legislation on the subject. The same system is still being followed, I understand.*

Mr. Johnson of Colorado. *Yes; the same system is being followed.* I know the Senator from Idaho took a very active part in having the legislation adopted in 1932. The Senator himself sponsored an amendment with respect to depletion in connection with the mining operations to which he referred."

The admissibility of such debates in interpreting the meaning of a Congressional Act was recently upheld by the Supreme Court of the United States in the case of *United States v. City and County of San Francisco,* 310 U. S. 16, 21, 84 L. Ed. 1050, 1055, where Mr. Justice Black, in writing the prevailing decision, quoted copiously from statements of senators and congressmen made during debates on a public land grant.

See also:

Standard Oil Co. v. United States, 221 U. S. 1, 50; 55 L. Ed. 619, 641,

and

Helvering v. Twin Bell Oil Syndicate, 293 U. S. 312, 322, 79 L. Ed. 383, 389.

We submit that the foregoing debate which ensued just prior to the enactment of the 1942 Revenue Act shows that Congress has never at any time countenanced the departure from the meaning of gross income as we have defined it. The debate was held during the address of Chairman George of the Senate Finance Committee, who had the bill in charge, and so far as the Congressional Record shows he acquiesced without comment in the interpretation placed upon the law by Senators Thomas and Johnson. The attitude of the Commissioner in this case is at distinct variance with the attitude of Mr. Paul, Treasury representative, as stated by Senator Johnson.

Most of the authorities interpreting Section 114 (b) (4) do not directly deal with metal mine products. There are, however, a number of cases which the Tax Court has cited as authority for its position, and we proceed to analyze them briefly, pointing out that they do not sustain the ruling made in this case.

Eisner v. Macomber, 252 U. S. 189, 207, 64 L. Ed. 521, 529, cited in the Tax Court's opinion (R. 102), defines income as follows:

"* * * 'Income may be defined as the gain derived from capital, from labor, or from both

combined,' provided it be understood to include profit gained through a sale or conversion of capital assets, to which it was applied in the Doyle Case (pp. 183, 185).

Brief as it is, it indicates the characteristic and distinguishing attribute of income, essential for a correct solution of the present controversy. The government, although basing its argument upon the definition as quoted, placed chief emphasis upon the word 'gain', which was extended to include a variety of meanings; while the significance of the next three words was either overlooked or misconceived,—*'derived—from—capital';—'the gain—derived—from—capital',* etc. Here we have the essential matter: *not* a gain *accruing to* capital, not a *growth* or *increment* of value *in* the investment; but a gain, a profit, something of exchangeable value *proceeding from* the property, *severed from* the capital, however invested or employed, and *coming in,* being *'derived',* that is, *received* or *drawn by* the recipient (the taxpayer) for his *separate* use, benefit, and disposal; *that* is income derived from property. Nothing else answers the description."

It is clear from this language of the Supreme Court that income cannot be considered as hypothetical increment to the value of petitioners' capital. *There must be an actual reduction to realized or realizable money value and there cannot be any such status until a marketable product is obtained.*

The Tax Court also cites *Crews v. Commissioner of Internal Revenue,* 89 Fed. (2d) 412 (C.C.A. 10–

1937). This case contains the following language at pages 415-416:

> "Income from property is a gain, a profit, something of exchangeable value derived from the property, that is received or drawn by the recipient (the taxpayer) for his separate use, benefit and disposal. Eisner v. Macomber, 252 U. S. 189, 207, 40 S. Ct. 189, 64 L. Ed. 521, 9 A.L.R. 1570; Merchants' L. & T. Co. v. Smietanka, 255 U. S. 509, 520, 41 S. Ct. 386, 65 L. Ed. 751, 15 A.L.R. 1305; Commissioner v. Independent Life Ins. Co. (C.C.A. 6), 67 F. (2d) 470, 472, reversed on other grounds; Helvering v. Independent Life Ins. Co., 292 U. S. 371, 54 S. Ct. 758, 78 L. Ed. 1311; Fordyce v. Helvering (C.C.A. 8), 78 F. (2d) 525, 528; Central R. Co. v. Commissioner (C.C.A. 3), 79 F. (2d) 697, 699, 101 A.L.R. 1448.
>
> The word 'derive' means 'to receive, as from a source or origin.' Webster's New International Dictionary (2d Ed.).
>
> *Hence gain or profit from property, though it comes into existence, does not become gross income until it is derived, that is received by the taxpayer.*
>
> This is a common sense construction of the section. To allow a deduction on the basis of income never received and therefore no part of the gross income, on the net part of which a tax is exacted would be manifestly unfair. While oil extracted and sold to the Refining Company depleted the land, the depletion allowance is not granted to create a depletion reserve but to allow a deduction from gross income for tax pur-

> poses and there should not be included in such gross income proceeds of oil never received by the taxpayer and no part of which became subject to income taxation." (Emphasis supplied.)

The Court there was dealing, among other things, with the identical section of the Revenue Act here under consideration. We can find nothing in its language which supports the Tax Court's views.

Another case cited on the same page of the opinion is *Helvering v. Mountain Producers Corporation,* 303 U. S. 376, 82 L. Ed. 907. The Supreme Court there said with respect to gross income basis for percentage depletion of oil wells (p. 382 U. S., p. 912 L. Ed.):

> "* * * The term 'gross income from the property' means gross income from the oil and gas (Helvering v. Twin Bell Oil Syndicate, supra) and the term should be taken in its natural sense. With the motives which lead the taxpayer to be satisfied with the proceeds he receives we are not concerned. If, in this instance, the development operations had failed to produce oil, it would hardly be said that the expense of drilling, borne under contract by another, constituted 'gross income' of the taxpayer within the meaning of the statute. Nor, when oil or gas is produced, does the statute base the percentage on market value. The gross income from time to time may be more or less than market value according to the bearing of particular contracts. *We do not think that we are at liberty to construct a theoretical gross income by recourse to the expenses of production operations.* The Refining Company for

its own purposes undertook the expense of those operations, and Wyoming Associated was content to receive as its own return the cash payments for the oil produced, leaving to the Refining Company the risks of production.

We are of the opinion that the cash payments made by the Refining Company constituted the gross income of Wyoming Associated and was the basis for the computation of the depletion allowance." (Emphasis supplied.)

It will be seen that the foregoing language of this opinion of the Supreme Court does not support the respondent's construction of "gross income" by adding hypothetical profit to costs.

Other cases cited are equally distinguishable. In *Helvering v. Bankline Oil Company,* 303 U. S. 362, 82 L. Ed. 897, the Supreme Court held that processors of natural wet gas, who purchased the wet gas from the producers and paid for it on the basis of a percentage of its gasoline content, were not entitled to percentage depletion because they were not the owners of the oil or gas in place, and had no economic interest in the gas in place or any capital investment in the mineral deposit which suffered depletion.

In *Greensboro Gas Co. v. Commissioner of Internal Revenue,* 79 Fed. (2d) 701 (C.C.A. 3-1935), percentage depletion was denied on the retail price of natural gas sold to consumers based on income received by the producer after the gasoline had been transported from the wells through gas main service pipes and meters to the consumer. This is of

course no authority in the case at bar where the petitioners claim only for the wholesale value of the first marketable product at the mine.

A like ruling was made in *Consumers Natural Gas Co. v. Commissioner of Internal Revenue,* 78 Fed. (2d) 161 (C.C.A. 2–1935).

Another case heavily relied upon by the Tax Court (R. 103) and by the respondent in his brief below, was *Brea Cannon Oil Co. v. Commissioner of Internal Revenue,* 77 Fed. (2d) 67 (C.C.A. 9–1935). That case was similar to the *Bankline Oil* case above mentioned. The Court said (p. 68):

> "* * * The sole question for our consideration then is whether or not the amount *actually received from the sale* of casinghead gasoline by the petitioner is subject to the allowance of 27½ per cent. for depletion, or whether the depletion should be estimated upon the market value of the gasoline content of the wet gas." (Emphasis supplied.)

Sixty per cent of the proceeds of the sale of such product was retained by the processing company, to whom the wet gas was sold, as consideration for its services. Forty per cent was paid to the producer.

That is exactly what we are contending for in the instant case—the amount received for the quicksilver content of the ore produced at the mouth of the mine.

The Court further points out (p. 70) that the wet gas is composed of two marketable products, dry gas and casinghead gasoline, is salable as such, and has a market value, whereas the water content of the

oil produced by a well is an impurity like the oil sand which is also sometimes mixed with the oil. The Court said further (p. 70):

> "* * * it is immaterial for the purpose of this case whether or not the Commissioner is correct in ignoring the dehydrating process in estimating the depletable base where the oil produced contained a large water content, if he is correct in limiting the petitioners herein to the *market value* of the casinghead gasoline content of wet gas produced from the petitioner's property." (Emphasis supplied.)

It thus implies that if the Commissioner had not allowed the full value of the first marketable products, deduction of dehydrating costs would have been disapproved as a basis for obtaining gross income. All that was disallowed was the claim of the petitioner that there should be added to the gross income which it actually received from the sale of its product at the well the costs of manufacturing a more refined product, to wit, separated casinghead gasoline. This was disallowed and the petitioner was relegated to depletion on what he actually received. That is all petitioners ask for here.

As distinguished from these decisions in oil cases, we note that in the case of *Lumaghi Coal Co. v. Helvering,* 124 Fed. (2d) 645, 648 (C.C.A. 8–1942), the Court held that the expense incurred in operating silos and storage plants in connection with a coal mine was attributable to the business of mining and selling the coal, and was therefore a part of the "overhead and operation expense" incurred in carry-

ing on the mining business. The Court distinguished it from the oil cases above cited, where natural gas was transported many miles through piping to retail consumers, saying (p. 648):

> "* * * But a coal mine in operation implies as a usual and customary incident some kind of a plant for the extraction of the coal and making it accessible for transportation. The addition of the silos and storage to the mine tipple of the taxpayer effecting more continuous service and larger volume of output can scarcely be said to have changed the nature of the mining or to have split what was concededly one activity into two. We do not find error to justify reversal in the Board's conclusion that 'the petitioner was engaged in but one activity' in the tax year."

We also call the Court's attention to the provisions of Subdivision (f) (2) of Regulations 103 which provide that in the case of sulphur, the cost of pumping to vats, cooling, breaking, and loading at the mine for shipment is not to be deducted from gross income from the product. These operations were no less elaborate or more necessary in order to obtain a marketable product than those, the cost of which was deducted in the instant case.

We submit that there is nothing in the quoted decisions which supports the interpretation placed by the Tax Court on Regulations 103 and the statute to which they are germane. So far as expert evidence may be considered in aid of interpretation, we respectfully point out to the Court that in the opinion evidence given by State Mineralogist Walter W. Bradley (R. 67-73), witness Worthen Bradley (R.

75-77), and witness Henry W. Gould (R. 80-81), the process of obtaining a marketable product for quicksilver ore by roasting was held to be quite similar in *effect* to the obtaining of marketable products from gold, silver, copper, and lead ores by concentration and through gravity or flotation. The processes were physical processes in both cases, and obtained economically similar results.

This Court said in *Commissioner v. Kennedy Mining & Milling Co.,* 125 Fed. (2d) 399, 400 (C.C.A. 9–1942):

> "* * * The right to deduct for depletion of a mine a percentage of the gross or net income therefrom does not depend upon the type of mill used in treating the ores from which such income is derived."

The respondent produced no evidence contradicting these views. The Tax Court ignored them entirely in concluding that the furnacing, condensing, cleaning and flasking beneficiated the product in a greater degree than crushing and concentrating because, the Court said, if the ore had been concentrated, a process which would have given it no economic beneficiation, it would have still required furnacing. The Court overlooked the proper construction of the word "beneficiation" which we think in order to conform with the statutory intent should be related to the first *marketable* product from the operation rather than to the *physical* state of the metal content of the ore—that is, whether it is free or in the form of concentrates or amalgam. Its physical or chemical condition has little or nothing to do with the fact as to whether

it is capable of producing an income. That is a question of economics.

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(3) IF, AS PETITIONERS CONTEND, QUICKSILVER IN FLASKS, READY FOR MARKET, IS THE FIRST MARKETABLE PRODUCT AT THE MINE, IT NECESSARILY FOLLOWS THAT THE RESPONDENT'S DEDUCTION OF COSTS OF FURNACING, CONDENSING, CLEANING AND FLASKING FROM THEIR GROSS INCOME FROM SALES OF QUICKSILVER WAS IMPROPER, AND THE TAX COURT ERRED IN UPHOLDING IT. (SPECIFICATION NO. 6.)

There is no dispute in the record as to what were the costs of furnacing, condensing, cleaning, and flasking the metal in each case. In the stipulation of facts, New Idria case (R. 43, 45, 47), Klau Mine case (R. 55 and Exhibit B to the stipulation contained in the typewritten record on appeal), in the Oat Hill Mine case (R. 57 and Exhibit B to the stipulation contained in the typewritten record on appeal), and in the Wild Horse case (R. 62, and Exhibit B to the stipulation contained in the typewritten record on appeal), the exact figures for these deductions are all separately set forth. These deducted items of cost were all incurred by the petitioners themselves in producing the metal. Therefore, if the Circuit Court of Appeals should uphold the contentions of petitioners herein, the figures are available in the record on appeal to make a re-computation of the gross income basis for percentage depletion, and upon a remand of the case the Court could order such cancellation or recalculation of the tax liability as it might deem proper under the circumstances.

(4) TO AN EVEN GREATER DEGREE, THE TAX COURT ERRED IN UPHOLDING THE ARBITRARY APPORTIONMENT AND DEDUCTION OF PROFIT SO APPORTIONED TO EACH OF THESE EXCLUDED MINING OPERATIONS ADOPTED BY THE RESPONDENT COMMISSIONER IN ASSESSMENT OF PETITIONERS' TAXES. (SPECIFICATIONS NOS. 7, 8 and 9.)

The respondent was not satisfied with deduction of actual costs of operations essential to obtain a first marketable product from the petitioners' mines. He also proceeded to divide up the total profit from petitioners' mining operations so as to apportion to each separate operation the proportion of the total profit that he says the cost of that operation bore to the total cost of all operations. He then deducted from gross income the proportion of these calculated "profits" which he had allocated to each of the deducted items of furnacing, flasking, etc. The Tax Court approved this practice without comment.

The deduction of a hypothetical profit ascribable to each operation is illogical and inequitable. The profit in mining does not arise out of the cost of mining and beneficiation. These costs merely reduce the profit. Profit arises from two elements, (1) the existence of metal in the ground in a form which can be beneficiated at a reasonable cost; and (2) the existence of a market for the metal which will yield a profit to the owner of the ground, over and above the total cost of extracting the marketable product from its place in the earth. The cost of that extraction includes mining, milling, and in some cases, smelting or furnacing, but they are all steps in the production of a marketable product from the ore in place. There would be just as much logic in deducting

the cost of mining and a proportionate profit, on the theory that ore at the surface is more valuable than it is in the ground, as there is in deducting the cost of furnacing on the theory that metal which has been furnaced is more valuable than metal which is in the ore. The essential point is that it is *not marketable* until it has been mined, crushed, furnaced, condensed, and flasked. The profit is an over-all profit and is in no sense attributable to any elements of cost. The total cost may furnish a minimum point at which the owner can afford to market his product, but that is all. The market price is not determined by the cost of mining or beneficiating the ore. It is determined by the law of supply and demand, and it attaches to the product itself, not to the costs of producing it. The gross return from one property will be higher or lower than the gross return from another property, but particularly in the case of quicksilver it will not be due to the difference in the cost of beneficiation processes, which are practically uniform in character in this country. It will be due to the element of competitive market price, grade of ore, accessibility of property and relative costs of mining and raising it to the surface. In the case of gold and silver, the domestic prices of which are fixed by law, the profits have no basis whatever in costs of production for a different reason.

The lack of logic in the respondent's reasoning is further accentuated by showing that computing "gross income from the property" by adding to the cost of mining and crushing an apportioned profit, based on the proportion that the cost of mining and

crushing bears to the total costs and calling the sum "gross income" will invariably make the "gross income" from a low-cost property *less* than the gross income from a high-cost property containing ore of equal grade—an obvious absurdity which does violence to the basic reasons for allowing depletion at all. This may be illustrated by the following examples:

Two adjoining mining properties have absolutely the same mineral content per ton, but one is operated at the surface (using shovels and trucks) and the other underground, with resulting variations in costs:

Property No. One

had 10,000 tons of 3 lb. ore; cost of mining $1.50 per ton	$15,000.00	(3/5)
Furnacing	10,000.00	(2/5)
Sales at $2.00 per lb.	60,000.00	
Net profit	35,000.00	
Net profit per ton $3.50, of which (on respondent's theory) 3/5ths is added to mining cost, or $2.10, making total "gross income" per ton $1.50+$2.10=	3.60	
Depletion = 15% of this	0.54	

Property No. Two

had 10,000 tons of 3 lb. ore; cost of mining $4.00 per ton	$40,000.00	(4/5)
Furnacing	10,000.00	(1/5)
Sales at $2.00 per lb.	60,000.00	
Net Profit	10,000.00	
Net profit per ton $1.00, of which (on respondent's theory) 4/5ths is added to mining cost, or $0.80, making total "gross income" per ton $4.00+$0.80=	4.80	
Depletion = 15% of this	0.72	

Both ores at the furnacing point are identical, and therefore of equal value, but by the arbitrary method used, the ore which cost $1.50 per ton to mine yields less "gross income" than the ore which cost $4.00 per ton to mine. The result is contrary to any logical reasoning which of course would ascribe higher value and consequently higher depletion per ton to the low cost ore in place and lower value and consequently lower depletion per ton to the high-cost ore in place, and the same value to both ores at the mine mouth.

We must remember that the intent of the law is to use a percentage of the "gross income from the property" as the *measure* of depletion. If actual selling price is used in determining the gross income, the appropriate variation in depletion base based on the varying metal content per ton of ore is automatically provided for. However, if segregated costs are used as a basis for determining market value, the logical variation is lost, because the mining cost of one mine will have a different mining or furnacing cost ratio to selling price than another mine, and although the content per ton might be exactly the same and therefore equal in value, yet differences in costs could result in considerable differences in resulting gross income value arbitrarily arrived at by the proposal of the Bureau. All the authorities hold that percentage depletion is a statutory yardstick to measure the loss in value of a wasting capital asset. That yardstick should not be applied so as to give the anomalous result of high depletion on high cost ore and low depletion on low cost ore—a reversal of the principle of value in place just stated.

The Tax Court in its opinion does not even pass on the assignments of error which are raised in the petitions (R. 6) and made no finding whatever as to the propriety of this deduction of arbitrarily assigned profits other than to generally uphold the Commissioner's deduction. The respondent himself in his brief below did not defend his method of apportionment other than to say that petitioners had not offered anything else. Of course petitioners did not offer anything else, because they do not believe that any profit is attributable to these operations. As pointed out, there are no custom mills or smelters that handle quicksilver ores or concentrates, and no basis of comparison of profits from such operations. So far as the petitioners are concerned, they had only one profit, due, as we pointed out, to existence of metal in the ground and a market for that metal. All costs of operation from mining to flasking reduced the amount of profit that would be otherwise available. The operation costs of such processes and the depreciation on the equipment involved therein were deducted as operating expenses and there was never any contemplation that the selling price of the product would in any way be related to those expenses and depreciation charges. The market price of quicksilver was in no sense determined by them. It was entirely a question of supply and demand coupled with the effect of actual or potential foreign computation, and since the war, O.P.A. ceilings fixed on the basis of the selling price in 1941.

We submit that the attempted apportionment of profits was entirely illogical and improper. Further-

more, so far as the 1939 cases are concerned, the profit computation was brought about by Treasury Decision 4360, which never was enacted until 1940, and has been given retroactive effect upon petitioners' income for past years, contrary to the rulings in *Helvering v. R. J. Reynolds Tobacco Co.,* 306 U.S. 110, 116, 83 L. Ed. 536, 541, and *Hesslein v. Hoey,* 91 Fed. (2d) 954, 956 (C.C.A. 2-1937).

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(5) PETITIONER NEW IDRIA QUICKSILVER MINING COMPANY WAS ENTITLED TO CLAIM PERCENTAGE DEPLETION ON INCOME FROM ORE MINED AND EXTRACTED FROM DUMPS ON ITS LAND, WHICH DUMPS WERE ALWAYS AN INTEGRAL PART OF ITS PROPERTY, HAD NEVER BEEN SEVERED IN TITLE THEREFROM AND AS TO WHICH NO DEPLETION HAD EVER BEEN CLAIMED PREVIOUSLY. (SPECIFICATION NO. 10.)

The Tax Court relies heavily upon the decision in *Atlas Milling Co. v. Jones,* 115 Fed. (2d) 61 (C.C.A. 10-1940), and upon two Tax Court opinions reported at 43 B.T.A. 254 and 46 B.T.A. 241, respectively. The Tax Court distinguishes the situation in the New Idria case from that which governed the decision in *Kennedy Mining & Milling Co.,* 43 B.T.A. 617, 125 Fed. (2d) 399, upon the grounds that the petitioner in the instant case acquired the land with the dump ores thereon, which had been taken from the same property by predecessors in title, whereas the Kennedy Mining Company itself mined the ore from its property and also, at a much later date, the piled up tailings from that ore. Petitioner claims that the last mentioned circumstance is a distinction without legal significance.

The dumps in the New Idria case consisted of two classes,—one, ore that was mined from the land on which they were situated prior to 1913, and had been left there and covered with subsequently mined waste because, under the state of the milling art as it was then known, it was of too low a grade to beneficiate. The other dump consisted of partially beneficiated ore which by means of the improvements in the refining practices was capable of yielding still further metal. No depletion had ever been claimed by previous owners on either of the ore dumps, both of which had been left upon the identical property from which the ores were mined prior to the date of the first income tax law, and it had therefore passed from owner to owner as a part and parcel of the real estate until acquisition by petitioner in 1936. In other words, there never had been any severance of legal title to the ore in the dumps from that of the land on which they were situated. It follows necessarily that there never had been any separate economic existence provided for such ores. They were simply raw materials, taken from the property, some of them partly beneficiated, the reduction of which to a marketable product was completed by this petitioner. The question now arises as to whether the petitioner as an owner within the same chain of title under which both land and operating ore dumps has always passed is entitled to claim percentage depletion on that portion of the value of those ores which was not extracted by previous owners. We submit that the decision of this Court, and for that matter of the Tax Court itself, in *Commissioner of Internal Revenue v. Kennedy Mining & Milling Co.,* 125 Fed.

(2d) 399 (C.C.A. 9-1942) is clearly in point. In that case the Commissioner had contended that only so much of the taxpayer's income as was derived from newly mined ore was income from the mine. This Court held (p. 400):

> "(1) The Commissioner's contention must be rejected. The tailings from which the taxpayer derived part of its gross income and all of its net income during 1935 and 1936 were ores. They were ores from the taxpayer's mine, just as were the newly mined ores which the taxpayer treated in 1935 and 1936. Income derived from the ores called tailings, as well as that derived from the newly mined ores, was income from the mine.
>
> It is true, but not material, that the ores called tailings were mined prior to 1935. The mining of ores and the receipt of income therefrom are seldom, if ever, simultaneous. The two events are usually months apart and not infrequently years apart. Thus income from a mine during a taxable year may, and usually does, include income from ores mined prior to that year.
>
> Nor is it material that these ores (now called tailings) were, prior to 1935, subjected to treatment whereby part of their gold content was removed. The ores so treated remained after such treatment, as they were before, the property of the taxpayer and were thereafter, as theretofore, ores from the taxpayer's mine. Income derived from their subsequent treatment was income from the mine, just as was that derived from their first treatment."

Fully recognizing the force of the *Kennedy* decision, the Tax Court says, nevertheless, that the

situation in the *Kennedy* case is not the situation before this Court. It contends (R. 106):

> "* * * The income which petitioner received from processed dump ores was not income from the operation of its mine. The dump ores had been removed from the mine long before the petitioner acquired the property and were not a part of the mine at any time during petitioner's ownership."

With due respect to the Tax Court, we say that these ores were just as much a part of the mine during the taxable years under investigation as they were in the *Kennedy* case, and the petitioner's beneficiation of those ores was just as much a continuation of ore beneficiation as was allowed in the *Kennedy* case. Petitioner had succeeded to every single right that the former owners of the land had had by virtue of ownership of the land to beneficiate the ore in the dumps. What possible legal distinction can there be in these rights because the petitioner happened to be a successor in interest rather than the identical person, as was the situation in the *Kennedy* case? We can see none.

If the situation were one where the dumps had contained ore taken from other properties, and hence might be classed as raw material not extracted from the lands in question, if the title to the dumps had been severed from that to the land and the operator of the dumps was not the owner of the land, we could perceive the basis for a claim of distinction in the economic status of the ores; but neither of those

circumstances exist in the case at bar. It would be just as logical to deprive a present day owner of the right to percentage depletion because ores in place had been discovered by a predecessor and hence the added value which they had given to the mine was not given by the present owner. Even though severance of title to the ore from title to the land, or severance of the ore itself physically from location on the land from which it was taken might destroy the right to claim depletion, a mere transfer of ownership of both the land and the ore dumps on it, coupled with a history of continuous unity of title and possession, certainly does not justify depriving the mine owner of the right to a deduction for depletion of what has always been a part of the mineral value of the land.

We are mindful of the decision in *Atlas Milling Co. v. Jones,* 115 Fed. 2d) 61 (C.C.A. 10-1940), denying the percentage depletion allowance to the lessee of a tailings pile, and note the language of the Court in that case which, we submit, distinguishes the facts there from the case at bar (p. 64):

> "* * * We are not here concerned with whether the life tenant or remainderman is entitled to a depletion allowance, nor whether, if the St. Louis Smelting & Refining Company had retained its interest in the tailings and had recovered the mineral content in the taxable year 1933, it would have been entitled to a depletion allowance. The question presented is whether, after minerals have been severed, removed from a mine and treated, leaving a residue of tailings, *and a third person owning no economic interest in the mine from*

> *which the minerals were taken enters into a contract to process the tailings and to pay the life tenant a specified royalty out of the mineral values recovered for the right so to do,* such third person, when he recovers mineral values from the tailings, suffers an exhaustion of a mine for which he may claim depletion." (Emphasis supplied.)

In the case of *Consolidated Chollar, Gould & Savage Mining Co. v. Commissioner of Internal Revenue,* 133 Fed. (2d) 440 (C.C.A. 9-1943), a situation quite similar to that in the *Atlas* case arose. This Court, after holding that ore material removed from a mine and dumped on ground not owned by the owner of the mine was not a natural deposit as to which the owner of the dump could claim depletion, made the same distinction for which we are here contending. Speaking through Judge Denman, the Court said (p. 441):

> "Petitioner contends that the deduction is warranted by our decision in Commissioner v. Kennedy Mining and Milling Co., 9 Cir., 125 F. 2d 399. We do not agree. There we held the depletion deduction allowable because the recovery of mineral was from tailings of partially worked ore from a mine and mill owned by a taxpayer, deposited on taxpayer's land adjacent to the mine and mill from which they came, and hence the recovery was a mere continuation and completion of the processing of mineral extraction begun in the removal of the deposited material from the mine to the tailings dump. We distinguished that case from Atlas Milling Co. v. Jones, 10 Cir.,

115 F. 2d 61. There the deduction was disallowed. The taxpayer extracting the ore from the tailings did not own the mine from which the tailings had come, and the tailings were held not a mine or other natural deposit.

With reference to the classification of 'mines, * * * and * * * other natural deposits' we are unable to see any distinction, with regard to their natural character as a mine or deposit, between deposited tailings from partial working in a mill and from mines not owned by the owner of the depositing lands, and the deposited ore which had been no more processed than the crushing and fracturing also coming from mines not owned by the owner of the land on which the deposit is made."

In *South Utah Mines & Smelters v. Beaver County,* 262 U.S. 325, 67 L. Ed. 1004, the Supreme Court passed on the right of the State of Utah to value as a metalliferous mine tailings separated and removed from the mining claims and placed on other lands, stating (p. 332):

"* * * The tailings, severed and removed from the mining claims, changed in character, *placed on other and separate lands,* and having an ascertained and adjudicated value of their own, in our opinion, constituted a unit of property entirely apart from the mine from which they had been taken." (Emphasis supplied.)

The Tax Court itself admits in its opinion (R. 105) the distinction which we have made in the *Atlas* case and *Consolidated Chollar* case, but declines to rec-

ognize that the identity of the ores in the New Idria dumps in title, in possession and in history with the land from which they came entitle them to be considered as partially mined and processed ores, on the residual valuation of which depletion may be claimed. This ruling we assign as error in view of the decision of this Court in the *Kennedy* case, *supra.*

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(6) PETITIONER OAT HILL MINE, INC. WAS ENTITLED TO DEDUCT FROM ITS TAX RETURN THE PAYMENT MADE TO THE PACIFIC GAS AND ELECTRIC COMPANY FOR POWER SERVICE. (SPECIFICATION NO. 11.)

The last contention is made on the principle that the law and the tax regulations entitle the corporate taxpayer to deduct from its gross income expenditures reasonably and necessarily incurred in operating its property which do not represent the acquisition of any capital item. The expenditure in question was nothing more nor less than an advance payment to a power company for service. The power company would not go to the expense of installing a transmission line leading to petitioner's property unless it were assured of a certain amount of income. The opinion of the owner's manager, as expressed in the evidence (R. 83-84), was that Oat Hill Mine, Inc. had prospectively about a three year operation. Since then it appears that the petitioner corporation has been disincorporated. The witness, Henry W. Gould, was its president and general manager, competent to make such an estimate. The respondent offered no

testimony whatever to rebut that opinion evidence. We think the equitable thing for respondent to have done would have been to allow this item of operating expense as a deduction prorated over the probable life of the operation, instead of disallowing it entirely. We are not advised as to whether the Government recovered an income tax payment from the Pacific Gas and Electric Company for the amount of this deposit or not, but if it did not it was not the fault of petitioner here. Oat Hill Mine, Inc. was out of pocket for that expense, received no capital item but only current electric service for it, and by reason of the short life of its operation will not be entitled to a refund against future power bills under the terms of its contract. We submit that disallowance of this deduction was erroneous.

CONCLUSION.

Fully appreciating that the question of allowance for percentage depletion is at best a technical one, that the right to depletion, as the Courts have frequently said, is "a grace" permitted by Congress and not an inherent right; fully appreciating that Section 114 (b) (4) of the Revenue Code is intended to be a statutory measure of the right of the taxpayer granted under Section 23(m) to recoup and deduct from gross income for a wasting capital asset; we assert with confidence that the respondent has strayed far from the intent of the statute in his treatment of these petitioners' returns. He has attempted to treat

as gross income crude ore in an unmarketable state. He has built up a hypothetical income by arbitrary additions of assumed profits to the actual cost of mining and crushing this ore. He has refused to allow depletion at all of the wasting values of the ore formerly mined from the identical land in question and in the course of being re-processed from the dumps. He has departed entirely from the statutory concept of a tax on income and by disallowing deduction of proper depletion allowance he is in effect taxing the capital of the petitioners as a part of their income. This has not been the intent of Congress in passing the income tax law, nor was it the intent of the Sixteenth Amendment to the Constitution under which that income tax law became permissible. The Tax Court has apparently followed the respondent in these misinterpretations of the statutory intent of Congress. We submit that its decision should be reviewed and reversed in all the particulars in which we have shown it to be erroneous.

Dated, San Francisco, California,
December 22, 1943.

Robert M. Searls,
Attorney for Petitioners.

(Appendix Follows.)

Appendix.

Appendix

FEDERAL STATUTES AND REGULATIONS REFERRED TO IN BRIEF.

Internal Revenue Code,

Section 23 (m). General provision for depletion of all natural deposits:

(m) *Depletion.* In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner, with the approval of the Secretary. In any case in which it is ascertained as a result of operations or of development work that the recoverable units are greater or less than the prior estimate thereof, then such prior estimate (but not the basis for depletion) shall be revised and the allowance under this subsection for subsequent taxable years shall be based upon such revised estimate. In the case of leases the deductions shall be equitably apportioned between the lessor and lessee. In the case of property held by one person for life with remainder to another person, the deduction shall be computed as if the life tenant were the absolute owner of the property and shall be allowed to the life tenant. In the case of property held in trust the allowable deduction shall be apportioned between the income beneficiaries and the trustee in accordance with the pertinent provisions of the instrument creating the

trust, or, in the absence of such provisions, on the basis of the trust income allocable to each."

(n) *Basis for depreciation and depletion.* The basis upon which depletion, exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be as provided in section 114.

Internal Revenue Code,

Section 114 (b) (4) contains the statutory measure of depletion of quicksilver mines and sulphur:

Section 114. Basis for depreciation and depletion.

(a) *Basis for depreciation.* The basis upon which exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be the adjusted basis provided in section 113 (b) for the purpose of determining the gain upon the sale or other disposition of such property.

(b) *Basis for depletion.*

* * * * * * *

(4) *Percentage depletion for coal and metal mines and sulphur.* The allowance for depletion under section 23 (m) shall be, in the case of coal mines, 5 per centum, in the case of metal mines, 15 per centum, and, in the case of sulphur mines or deposits, 23 per centum, of the gross income from the property during the taxable year, excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the prop-

erty. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property.

Treasury Regulations 103, interpreting Section 114 (b) (4) read as follows:

Sec. 19.23 (m)-1. Depletion of mines, oil and gas wells, other natural deposits, and timber; depreciation of improvements.—

* * * * * * *

When used in these sections (19.23 (m)-1 to 19.23 (m)-28, inclusive) covering depletion and depreciation—

(f) "Gross income from the property", as used in section 114(b)(3) and (4) and sections 19.23(m)-1 to 19.23(m)-28, inclusive, means the amount for which the taxpayer sells the crude mineral product of the property in the immediate vicinity of the mine or well, but, if the product is transported or processed (other than by the processes excepted below) before sale, it means the representative market or field price (as of the date of sale) of crude mineral product of like kind and grade before such transportation or processing. If there is no such representative market or field price (as of the date of sale), then there shall be used in lieu thereof the representative market or field price of the first marketable product resulting from any process or processes (or, if the product in its crude state is merely

transported, the price for which sold) minus the costs and proportionate profits attributable to the transportation and the processes not listed below. The processes excepted are as follows:

(1) In the case of coal—cleaning, breaking, sizing, and loading at the mine for shipment;

(2) In the case of sulphur—pumping to vats, cooling, breaking, and loading at the mine for shipment;

(3) In the case of iron ore and ores which are customarily sold in the form of the crude mineral product—sorting or concentrating to bring to shipping grade, and loading at the mine for shipment; and

(4) In the case of lead, zinc, copper, gold, or silver ores and ores which are not customarily sold in the form of the crude mineral product—crushing, concentrating (by gravity or flotation), and other processes to the extent to which they do not beneficiate the product in greater degree (in relation to the crude mineral product on the one hand and the refined product on the other) than crushing and concentrating (by gravity or flotation).

In case any of the excepted processes are not applied in the immediate vicinity of the mining district in which the mine is located, costs incurred for transportation to the processing location and, if transported by taxpayer, the proportionate profits attributable to transportation should be subtracted from the sale price of the product to determine "gross income from the property".

In the case of oil and gas, if the crude mineral product is not sold on the property but is manufactured or converted into a refined product or is transported from the property prior to the sale, then the "gross income from the property" shall be assumed to be equivalent to the market or field price of the oil or gas before conversion * * *.

(g) "Net income of the taxpayer (computed without allowance for depletion) from the property" as used in section 114 (b) (2), (3), and (4) and sections 19.23(m)–1 to 19.23(m)–28, inclusive, means the "gross income from the property" as defined in paragraph (f) of this section less the allowable deductions attributable to the mineral property upon which the depletion is claimed and the allowable deductions attributable to the processes listed in paragraph (f) in so far as they relate to the product of such property, including overhead and operating expenses, development costs properly charged to expense, depreciation, taxes, losses sustained, etc., but excluding any allowance for depletion. Deductions not directly attributable to particular properties or processes shall be fairly allocated. To illustrate: In cases where the taxpayer engages in activities in addition to mineral extraction and to the processes listed in paragraph (f), deductions for depreciation, taxes, general expenses, and overhead, which cannot be directly attributed to any specific activity, shall be fairly apportioned between (1) the mineral extraction and the processes listed in paragraph (f) and (2) the additional activities, taking into account the ratio which

the operating expenses directly attributable to the mineral extraction and the processes listed in paragraph (f) bear to the operating expenses directly attributable to the additional activities. If more than one mineral property is involved, the deductions apportioned to the mineral extraction and the processes listed in paragraph (f) shall, in turn, be fairly apportioned to the several properties, taking into account their relative production.

(h) "Crude mineral product", as used in paragraph (f) of this section, means the product in the form in which it emerges from the mine or well.